# FX Daily: Talking up the euro

The highlight of today's European FX session will be the ECB meeting. The ECB will welcome the 2% recovery in the trade-weighted euro over the last month and will no doubt look to keep its options open on the speed of the tightening cycle. Yet further euro gains will be hard-won against the strong dollar and we doubt any EUR/USD spike above 1.08 is sustainable


## USD: Biding its time near the highs

There is a complex layer of stories at play in FX markets at present. Risk assets have temporarily stabilised and US activity data is holding up such that investors remain happy to price a Fed terminal rate up at 3.25% next year. This is keeping the dollar generally strong. Yet, the hawkish turn from the European Central Bank and others over the last month has provided some support to European currencies - even though those currencies are challenged by surging energy prices on the planned Russian oil embargo. Higher energy prices are also taking their toll on the currencies of the big energy importers of Japan and Turkey. At the same time, some high-yielding emerging market currencies such as the Mexican peso and South African rand are performing well - again probably buoyed by high commodity prices.

In all, we would probably expect continued outperformance of the North American currencies, since it seems that US consumption is holding up and it looks far too early to call time on the Fed tightening cycle. Next week's FOMC meeting will provide an update on the Dot Plots and we will get to see how much the median dot pushes above 3.00% for end-2023 expectations of the Fed policy rate. (In March, that median expectation for end-23 was at 2.8%).

There is little US data today and the next big input will be tomorrow's US May CPI - where the White House is already warning of a high number. With that in mind, we expect the dollar to continue consolidating near the highs and DXY to trade in a 102-103 range. As to USD/JPY which got close to 135 yesterday, there seems no reason to try and pick a top. Despite one-month traded USD/JPY volatility being back above 12% it seems hard to describe conditions as disorderly. And so far, the BoJ does not seem particularly concerned by weakness in the yen.

## EUR: A lot of tightening priced in

ECB day will see a policy announcement at 13:45CET and the press conference at 14:30CET. As Francesco Pesole discusses here , we think an independent 20bp move in two-year EUR swap rates may be worth a 1.2% adjustment in EUR/USD. That swap rate is currently 1.35%. Can that spike above 1.50% today, taking EUR/USD up to the 1.0850 area? That is not impossible, but we would say that eurozone money markets price quite an aggressive ECB cycle already. In particular, they price five 25bp hikes for four live (July, September, October, December) ECB meetings this year. We doubt the ECB will want to pour cold water on this pricing since its hawkish turn over the last month has managed to lift the trade-weighted euro some 2% off its lows seen in early May. One can see then why the euro has remained quite resilient this week.

Ultimately, however, we do not think any EUR/USD spike above 1.08 will last too long given that we like the dollar story this summer and Europe is sadly on the front line of the stagflationary shock of the war in Ukraine. Please see our full ECB preview here for all the details of today's meeting including the fresh round of forecasts and speculation on the new anti-fragmentation scheme that will allow the ECB to hike without destroying the sovereign bond markets of southern Europe.

Elsewhere, there should be continued focus on the CE3 currencies. The National Bank of Poland will hold a press conference after yesterday's 75bp hike. We think the market still under-prices the size and duration of the tightening cycle and we continue to favour the Polish zloty. In the Czech Republic, the Czech National Bank (CNB) board did change in line with yesterday's rumours and investors will be pricing a more dovish CNB going forward - though the CNB may continue to intervene to keep EUR/CZK below 24.70/25.00 for the near term. And in Hungary, the soft forint will again see the market focus on whether the National Bank of Hungary feels the need to adjust its 6.75% one-week deposit rate. Unlikely, but any ECB hawkishness could see EUR/HUF pressing 400 again.

## GBP: Bracing for the ECB

The run-up in EUR/GBP to the 0.8560 region looks a function of positioning for the ECB rather than any negative re-assessment of sterling, per se. As above, we cannot rule out a temporary spike higher in the euro today, although we doubt EUR/GBP sustains any move above 0.8600. After all, the eurozone faces many of the same challenges faced by the UK and it may be a little too early for the Bank of England (BoE) to pour cold water on market expectations of an aggressive tightening cycle. BoE/Ipsos inflation expectations released tomorrow may be the next important input here.

## ZAR: Resilient

The South African rand has certainly been more resilient than we had expected - making a very impressive recovery from above 16/USD in early May. The move is all the more impressive since the jury remains very much out on the Chinese growth story (no clear signs of a major turnaround here).

We still have our doubts about the longevity of this recovery in the rand. We would still much more prefer the Mexican peso in the emerging market high yield space. For today, look out for the South African 1Q22 current account release at 11CET. This is expected at a 1.5% of GDP surplus. Commodity price gains have certainly improved South Africa's external position, but with US real rates set to go higher this summer, we suspect USD/ZAR will likely end up closer to 16 than 15 over the next one to two months.

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